

**Assessing the Preconditions in Establishing an Independent Regulatory and Supervisory Agency  
in Globalized Financial Markets: The Case of Turkey\***

**Abstract**

Recent financial crises highlight weaknesses in financial markets and the need for regulatory and supervisory bodies (RSB) to improve the stability of financial markets. Currently, international institutions like the IMF and the World Bank place the independent RSB among their principle policy recommendations to developing countries. This paper acknowledges the importance of independent RSB for the proper functioning of financial markets. However, this paper also points out the preconditions to establish independent RSB. Unless certain prerequisites are satisfied, policy recommendations to construct an independent RSB are doomed to fail. The recent Turkish experience is provided as a case study to elucidate this conclusion. This paper first presents the arguments for independent RSB and the policy recommendations in institution building for stronger financial system. Then, the background of Turkish experience for independent RSB is provided. Finally, we analyze the primary reasons for the deficient performance of Turkish RSB over the last five years in an attempt to provide actual lessons for the future institutional reforms.

**Keywords:** Regulation, Supervision, Financial Markets, Banking, Institutional Building, Reform, IMF, The World Bank

**JEL classification:** F21, G21, O19

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# **Assessing the Preconditions in Establishing an Independent Regulatory and Supervisory Agency in Globalized Financial Markets: The Case of Turkey**

## **I. Introduction**

Turkey has experienced recurrent crises in 1994, 2000 and 2001. Weaknesses in Turkish financial markets have constituted the major reason behind these twin-crisis episodes. Hence, these recent crises in Turkey have elucidated the importance of well-functioning financial system for the macroeconomic stability. East Asian crisis in 1997 has also highlighted the same issue in a more global environment. In the East Asian crisis, deficiencies in financial markets of these countries have emerged as an instrumental domestic reason for the crisis in addition to international factors related to the functioning of international markets like contagion. In addition to these well-known cases, many developing countries have either experienced the financial market crises or come very close to economic turmoils stemming from the problems in financial markets especially with the escalating liberalization and globalization of financial markets in the recent decades.

These observations have also motivated the international institutions to concentrate more on weaknesses in domestic financial markets<sup>\*</sup>. In May 1999, both IMF and the World Bank launched a joint mission related to the IMF's surveillance system and the World Bank's financial sector development program. This joint program is denoted as Financial Sector Assessment Program. The main objectives of this collaboration are to enhance resource utilization of these institutions, to reduce

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<sup>\*</sup> There seems to be less concrete steps taken to deal with the problems associated with the functioning of international financial markets like rational panics and contagions which are very much related to short term capital flows in international financial markets.

multiplicative work that is conducted by both institutions, to ensure consistency of policy advice of both institutions, and finally to enhance legitimacy of their programs.

Regulation and supervision of financial markets arises as a focal issue in this initiative due to the importance of timely regulation and supervision to fix the deficiencies in the financial markets and to avoid experiencing recurrent financial crises. The increasing concern for healthy regulation and supervision of domestic financial markets reflects itself in the policy recommendations of the international institutions especially after the crises. Turkey is not an exception. Turkish governments after the latest crises have been confronted with the detailed policy recommendations by the IMF to establish a sound and independent regulatory and supervisory institution to control the banking sector in Turkey. Under strict guidelines of the IMF, Turkey has taken major steps to establish an independent regulatory and supervisory agency responsible for regulating the banking sector in Turkey. Finally, Turkey has set up an independent authority which is referred as Banking Regulation and Supervision Agency (BRSA). In spite of a certain degree of success, Turkish experience in forming an independent authority to regulate the financial markets has shown that certain preconditions need to be satisfied before establishing a new institution in a top-down manner.

We analyze the evolution of the BRSA starting from its establishment stage to the present. Turkey fails to generate necessary conditions for the functioning of an independent and strong BRSA. We explain these conditions under nine categories. First, the status-quo bias in favor of traditional modes of governance constrains the BRSA to involve in necessary reforms in Turkish banking sector. This bias leaves the BRSA without political support against the interest groups in Turkish financial system. High concentration ratio in Turkish banking sectors also arises as a major

challenge for the independent operations of BRSA. A small number of state-owned banks and private banks comprise a major share of Turkish banking sector. The existence of big state-owned banks restrains the actions of BRSA by rendering political influence on its policy decisions. Similarly, big Turkish banks opt to lobby for political influence on the BRSA when their interests are threatened by the decisions of the BRSA.

Some of the reasons for the failure of effective and independent BRSA are attributable to the initial organizational structure of BRSA. When the BRSA has been founded, various employee groups with conflicting organizational backgrounds have been assigned to the BRSA. The clash of organizational mentality of these various employee groups appears to be preventing the efficient functioning of BRSA. This conflict also reflects itself as a lack of budgetary independence for the BRSA. Moreover, the Turkish laws impose restrictions on the BRSA's board members not to work for the private banks after the terminations of their positions. These limitations deter the qualified personnel to undertake upper level responsibilities by considering their prospective financial losses in the future. This incentive structure, however, exposes the board members to even more political influence considering that the political domain remains to be the only option after the termination of their terms at the office. The BRSA also suffers from the lack of well-defined rules which enhance the accountability and transparency of the BRSA and hence provide a safer environment for the BRSA officials.

Others reasons for the failure of BRSA in effectively regulating the banking sector can be only tackled at the macro level. For example, lack of regulatory forbearance has led to confusions about the decisions of BRSA over the last five years and undermined the independent and efficient functioning of the BRSA. Tough

decisions of the BRSA have led the many employees in financial sector to lose their jobs. This result has compounded with the lack of well defined accountability of BRSA and in turn led to mounting pressure from the public against the actions of BRSA. Finally, conflicting and strict policy recommendations of the IMF have constrained the flexibility and competency of the independent BRSA.

All these factors for the failure of the BRSA in Turkish context point out the significance of certain preconditions in constructing independent regulatory and supervisory agencies. This historical episode in the construction of Turkish BRSA over the last five years has important ramifications for the other developing countries which are likely to follow the similar procedures to establish independent regulatory and supervisory institutions for their financial markets.

The paper is organized as follows. We first explain the Financial Sector Assessment Program (FSAP). In Section 3, IMF and the World Bank's suggestions for financial sector regulatory and supervisory bodies (RSB) are presented. The paper also analyzes the independency of RSB as being a central issue of FSAP in Section 4. In analyzing the independency of RSB, we concentrate solely on separate and independent RSB, as opposed to regulatory and supervisory function performed by the central banks. The independency of Turkish BRSA is explored as a case study in Section 5. We discuss the institutional impediments for independent regulatory and supervisory institution in the Turkish context in Section 6. The conclusions of this paper which is presented in Section 7 can be generalized to other developing countries which confront with the comparable issues in establishing independent regulatory and supervisory authorities.

## **2. Overview of the Financial Sector Assessment Program**

International Monetary Fund (IMF) and the World Bank (WB) were created after Bretton Woods Conference in 1944. IMF was charged to maintain order in international monetary system and to help solving balance of payment problems of the member countries. The World Bank was also deliberated to promote economic development. The main purposes of these institutions have remained unchanged. Over time, however, their operations have expanded in accordance with the changing needs of the member countries.

Currently, IMF has three main operations; surveillance, financial assistance and technical assistance. Surveillance today, arises to be the most important operations for IMF. Surveillance refers to maintain a dialogue with member countries on the national and international consequences of their economic and financial policies. IMF also provides financial assistance to member countries to rebuild their international reserves, to stabilize their currencies and to continue paying for imports without having to impose trade restrictions or capital controls. Finally, IMF provides technical assistance to member countries to contribute to the development of the productive resources of member countries by enhancing the effectiveness of economic policy and financial policy.

The World Bank's main purpose, at the moment, is defined as poverty reduction and enhancing the development prospects of member countries. Operations of the World Bank to improve the financial systems of member countries are also relevant in this paper in addition to the IMF activities related to the financial markets<sup>†</sup>.

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<sup>†</sup> See Hilbers (2001) for the detailed description of IMF and the World Bank programs in financial structuring.

After increasing sequence of financial crises in emerging markets, both IMF and the World Bank have much more extensively concentrated on the financial markets of developing countries. Prior to this increasing attention, the main concern for the IMF was to enhance macroeconomic stability. Hence, the detailed policy recommendations concerning the financial system were rare. In the 1980s and the beginning of 1990s, many countries liberalized their financial systems and a significant fraction of these countries experience twin crises in the subsequent years. Due to the experiences of crisis-ridden economies, IMF has concentrated more on the links between financial system soundness and macroeconomic stability (Fischer, 2000). With liberalization and globalization of financial markets, weaknesses of financial system emerged as a vital issue especially considering contagious effects of recent financial crises. Many IMF and the World Bank member countries, both industrialized and developing, have experienced financial crises in 1980s and 1990s. The severity of financial crises has shown the importance of well-regulated financial markets especially the banking sector in creating financial stability not just for individual countries but for the world economy as a whole (Onis & Aysan, 2000 and Conthe, 2001).

After the financial crises of the late 1990s, IMF and the World Bank initiated Financial Sector Assessment Program to evaluate member countries' financial markets. The main goal of this program is to help member countries enhance their resistance to financial crises and their contagious effects by promoting safety and soundness of financial markets. To this end, IMF and the World Bank aim to provide a sound framework for financial sector vulnerabilities and to improve the analysis of macroeconomic and financial stability issues, in addition to helping national financial

authorities to develop policy responses against the early indicators of financial distress.

The FSAP program of IMF and the World Bank has three main components:

1-an assessment of stability of the financial system in an attempt to conceptualize the bidirectional relationship between macroeconomic factors and financial stability.

2-an assessment of the extent to which relevant financial sector standards, codes, and good practices are observed

3-an assessment of the financial sector's reform and development needs

The IMF and the World Bank employs certain tools and methodologies to determine these three assessments. Macro-prudential analysis concentrates on the link between macroeconomic performance and financial sector soundness and it benefits from stress test and scenario analysis. Standards, codes and observances aim to identify discrepancies in financial sector regulation and transparency practices of member countries and their potentially best practices. Reform and development needs are also covered by these standards (Hilbers, 2001). Currently, under this program, there are almost over 283 assessments of standards and codes. These standards consist of six main components as follows:

- i) IMF Code of Good Practices on Transparency in Monetary and Fiscal Policies
- ii) Basel Core Principles for Effective Banking Supervision (BCP)
- iii) Core Principles for Systematically Important Payment Systems
- iv) International Organization of Securities Commissions Objectives and Principles of Securities Regulation



- v) International Association of Insurance Supervisors Insurance Core Principles,
- vi) Financial Action Task Force (FATF) Recommendations for Anti-Money Laundering and Combating the Financing of Terrorism.

There are also some other guidelines to use under FSAP<sup>‡</sup>: i) the OECD Corporate Governance Principles; ii) World Bank Principles for Effective Insolvency and Creditors Rights; iii) CPSS-IOSCO Recommendations for Securities Settlement System (RSSS); and iv) International Accounting and Auditing Standards<sup>§</sup>.

### **3. IMF and the World Bank's Policy Recommendations for Regulatory and Supervisory Institutions**

#### **3.1. A Background of the Recommended Policies**

Over the last twenty years, it has been a common trend for many developing countries to liberalize their economies. In retrospect, this period appears to be characterized with recurrent financial crises especially in the form of twin-crises. Many institutional and macroeconomic factors have played significant roles in the crises. However, banking sector problems have been always central in these crises (Mishkin, 2001). Moreover, with the advent of new globalization wave in recent decades, national financial markets are much more integrated in global financial system. Hence, a financial crisis can easily and abruptly spread over the rest of the world and pose a great threat for the stability of global financial markets. Because of contagion effect, for example, providing financial system stability emerges to be the

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<sup>‡</sup> With respect to the independent regulatory authority issue, Basel Core Principles for Effective Banking Supervision (BCP) also set up certain standards for financial sector, especially for financial sector regulatory bodies.

<sup>§</sup> For detailed information about the characteristics of the FSAP program, one can check IMF, 2003.

main goal of the IMF and the World Bank's policy recommendations for financial markets.

As a result of these considerations, a new line of research both in international financial institutions and in academia focuses on deficiencies in financial markets and deduces new policy recommendations about the prudential regulation and supervision of financial systems (Rossi, 1999). The main objective of these suggestions is to reduce financial fragility and to provide financial stability.

### **3.2. Policy Recommendations of International Organizations for Effective Regulatory and Supervisory Institutions**

Mishkin (2001) categorizes policies to enhance financial stability under twelve sections<sup>\*\*</sup>. Central one related to this paper is prudential regulation of financial sector. Unless the prudential regulation is provided in financial markets, it is hard to prevent recurrent financial crises due to well-known moral hazard and adverse selection problems. Hence, many governments attempt to establish well-designed regulatory and supervisory system to sustain stable financial markets. There are several important elements that must be provided for the strong prudential supervision like prompt corrective action, prudent risk management, limiting too-big-to-fail, a statutory authority for prudential regulators/supervisors, accountability of supervisors and restriction on connected lending<sup>††</sup> (Mishkin, 2001). Moreover, both the IMF and

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<sup>\*\*</sup> These policies are prudential regulation, accounting and disclosure requirements, legal and judicial systems, market-based discipline, entry of foreign banks, capital controls, reduction of the role of state-owned financial institutions, restriction on foreign-denominated debt, elimination of too-big-to-fail in the corporate sector, sequencing financial liberalization, monetary policy and price stability, exchange regimes and foreign exchange reserves (Mishkin, 2001, p.17)

<sup>††</sup> This paper especially focuses on importance of independence of regulatory/supervisory agencies by referring to Turkish experience in recent years.

the World Bank's policy recommendations to developing countries evolve around the same idea for better prudential regulation and supervision.

This theme also constitutes Basel Core Principles for Effective Banking Supervision. There are 25 basic principles in Basel Core Principles to create effective supervisory system<sup>‡‡</sup>. The first core principle consists of six sub-parts and utterly related to supervisory agencies. This principle deals with the definition of responsibilities and objectives for supervisory agency in addition to skills, resources, legal framework, enforcement powers, adequate legal protection for supervisors, and information sharing for an independent supervisory agency<sup>§§</sup>.

#### **4. Independency of Regulatory and Supervisory Body: Whither Desirable or not?**

In this section, we analyze the merits of independence for regulatory and supervisory authorities. The advocates of independent RSB point out that effective banking is merely achieved through an independent RSB. To this end, RSB needs to be sheltered against the political influence and unnecessary lawsuits. RSB needs to be equipped both with budgetary independence and operational independence. These remarks are quite often pronounced by international organizations to establish independent RSB. For example, the review of Bank of International Settlement<sup>\*\*\*</sup> in

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<sup>‡‡</sup> These principles are related to objectives, autonomy, powers and resources (1 core, 6 sub), licensing and structure (4 core), prudential regulations and requirements (10 core), methods of ongoing supervision (5 core), information requirements (1 core), remedial measures and exit (1 core), and cross-border banking (3 core).

<sup>§§</sup> See the official web page of the Basel for details on core principles, [www.bis.org](http://www.bis.org).

<sup>\*\*\*</sup> For the details of this review, check the web page of Bank of International Settlement at [www.bis.org](http://www.bis.org).

sixty countries highlights importance of independency of supervisory authorities among their three main results pertaining to be improved in these countries<sup>†††</sup>.

The independency of RSB is also indispensable for prudential supervision. Existing literature on financial market crises shows that the lack of independent RSB leads to corporate weaknesses before the crises and further aggravates the severity of the financial crises like in East Asian crisis (Kaminsky & Reinhart, 1999; Calomiris & Beim, 2001). Political interference in the supervisory process generally appears “*to sweep problems under the rug*” and postpones the recognition of the severity of the crises and thereby delays an effective intervention to financial system (Quintyn & Taylor, 2002 and Mishkin, 2001).

Establishment of an independent authority, as opposed to government agency, provides barriers for interference from the political arena and the financial sector. Moreover, Independent RSB enables to create a professional structure that exclusively concentrates on its own operations in regulating the financial markets. This specialized organization is more prone to solve complex issues. This independent body also improves transparency, public confidence and financial stability.

There are two dimensions of independency of RSB. The first one is independence from political interference. The second one is less emphasized as compared to the first one. However, it is at least as important as the first one to maintain the independence of RSB. Then, the second one is the independence from the supervised entities like banks in the financial sector. The latter one can also be framed as freedom from “regulatory capture”. Because of the dominant role of the banks in emerging financial markets, they apply a notable pressure on RSB. In addition to the banks, some powerful companies connected to the banks tend to

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<sup>†††</sup> For further evidence on the arguments of international organizations, one can also check IMF and the World Bank, 2002.

increase their pressure especially when their interest is at stake before and after financial turmoils. These pressures are explicitly and implicitly reflected in the decisions of RSB. Given that these two types of pressures undermine the regulatory and supervisory roles in financial markets, independence from the interference of political and supervised entities appears to be a common consensus to accomplish better regulatory governance.

There are however, certain drawbacks of having fully independent RSB. Extreme independence of RSB may not be desirable especially in democratic countries where politicians are elected for having certain policy objectives. Politicians are accountable for their political agenda whereas the RSB is not directly accountable to electorate and may deviate from the public opinion in exercising its independent authority. The power given to RSB is likely to create a principal agent problem when RSB has a different objective function than its principal (Das & Quintyn, 2002). Other adverse outcomes of independent RSB are associated with generating new institutional rigidities and imposing tight-regulations over the industry, which aggravates to the cost of doing business (Quintyn & Taylor, 2002). Given this considerations, the politicians do not want to create a “fourth branch of government” in addition to legislative, executive and judiciary branches

In spite of some undesirable consequences of independent RSB, some recent papers provide alternative models to account for these negative factors (Majone, 1993). Dialogue model for example, offers a new framework to reduce these negative factors. In this model, independent RSB does not act as an irresponsible or headless fourth branch but interact with political authorities in carrying out its regulatory and supervisory responsibilities. In Dialogue model, an independent RSB is subject to

self-imposed censor which gives the political authority an opportunity to communicate their political agenda to the RSB.

Another solution for the harmful aspects of independent RSB is to provide well-defined principles for the functioning of independent RSB such that RSB does not exceed the boundaries of its authority. To this end, accountability of RSB needs to be established. This is a “sine qua non” principle for the independence because it enables RSB to justify its actions against its designated responsibilities. Another vital feature is transparency. Requirement for certain level of transparency limits RSB’s self-interested actions and provides checks on the RSB to pursue its predefined objectives. In addition to these features, integrity among RSB’s staffs needs to be provided in order to ensure that the RSB’s staffs can collectively pursue institutional goals (Das & Quintyn, 2002). Moreover, Abrams & Taylor (2000) emphasize that the objectives of RSB need to be defined clearly and the RSB needs to be equipped with adequate resources and effective enforcement powers along with the provision of legal protection for its actions.

It is undeniably the case that many countries have made significant improvements for the independent RSB in recent decades. They have restructured regulatory and supervisory function under one roof. However, this process has been very thorny for many countries because of the political economy factors like strong status quo biases in governing the financial markets, conflicts among interest groups and politicians involved. Barth, Caprio and Levine (2001a) analyze 107 countries and find out that developing countries display much lower scores as compared to developed countries. For example, independency of RSB reaches to its highest level in European Union countries whereas the South Asian countries display lower levels of RSB independence.

To establish an independent RSB is not a single solution to prevent financial sector weaknesses and reduce financial instability. At the same time, financial system needs to be empowered by creating a well-designed legal environment. Furthermore, Barth, Caprio and Levine (2001b) show that the independence of RSB depends on a strong private sector monitoring, regulatory restrictions on bank activities and the level of moral hazard problem associated with deposit insurance policy.

## **5. A Case of Independent RSB: Turkish BRSA**

### **5.1. Overview of IMF's Policy Recommendations for Independent RSB in Turkey**

Turkey has adopted his first IMF program in 1958. Since then, Turkey has had periodic macroeconomic crises several times and implemented various IMF programs. IMF programs in Turkey are used to be concentrated on structural macroeconomic problems like budget deficits and high inflation (Alper, 2000; Alper et al. 2001; Akcay et al. 2001; Onis, 2003, Akcay, 2003). However, in recent IMF programs, the particular policy recommendations to cure weaknesses in Turkish financial markets have been central.

Turkey has made a stand-by agreement with the IMF in December 1999 for a three-year period program<sup>\*\*\*</sup>. In this agreement, structural problems in banking system and restructuring of banking sector have emerged among the IMF priorities. With this new program, IMF has sought to create strong regulatory agency in Turkey. Before the stand-by agreement, in June 1999, Turkish parliament has approved a new banking law that has created a new supervision authority which is the Banking Regulation and Supervision Agency (BRSA). This new law has brought an end to

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<sup>\*\*\*</sup> The web page of Turkish Treasury provides a detailed account of various IMF programs in Turkey For further details about content of this program, one can check: [www.treasury.gov.tr](http://www.treasury.gov.tr).

multiple duties played by the Turkish Treasury and Central Bank in regulating the financial markets in Turkey.

In the Turkey's letter of intent dated December 9, 1999 to the IMF, strengthening the banking system and banking regulation is listed as an important benchmark for structural reforms. According to this letter of intent, The Banks Act would be amended to redesign the banking supervision structure on a proper foundation in order to increase transparency and independence in the operation of BRSA. This letter represents the intentions of Turkey to strengthen key prudential regulations and to provide all of the tools needed for the improved resolution of troubled banks.

The BRSA is deliberated to be fully autonomous by removing the involvement of the Council of Ministers from all decisions in the area of supervision, other than the appointments of the members of the Board. The Banks Act has also been amended to strengthen the prudential standards for the bank lending to owners and to single or related parties.

## **5.2. Establishment and Restructuring of BRSA**

The BRSA has legally taken on all responsibilities granted to it by the Banking Law approved in June 1999 and become fully operational as of end-August 2000. Banking evaluation and supervision departments at the Treasury and the monitoring department at the Central Bank have been closed and their staff has been transferred to the new agency, including staff of the Savings Deposit Insurance Fund (SDIF), which has now become a legal entity administered by the BRSA. Some staffs have been transferred from the Ministry of Finance and the State Planning Organization. Finally, some additional required staffs have been hired. An Asset



Management Unit (AMU), in charge of recovering the value of the assets of the banks taken over by the SDIF, was also set up to execute an efficient management of assets transferred to the SDIF. With this new structure, the BRSA monitors the conditions of all banks through off-site analysis of bank balance sheets and income reports and through on-site examinations.

This IMF-led economic reform program of Turkey had two main goals: defeating the chronic and persistent high inflation of the 1990s, and overcoming the associated macroeconomic instability, which had constrained economic growth throughout the 1990s. During the original three-year program initiated in December 1999, Turkey has reformed the banking sector through an operational and financial restructuring of public banks, and by strengthening the regulation and supervision of private banks. However, the actual reason behind this success is attributable to last two financial crises of Turkey in November 2000 and February 2001. Crisis-ridden Turkish economy has taken major steps in reforming the financial system. In this respect, Turkish experience after the crises arises as a proper example for the arguments that crises induce economic reforms (Alesina & Drazen, 1991; Easterly & Drazen, 2001).

At the end of original three-year program initiated in December 1999, Turkey and IMF have signed another stand-by agreement in January 2002. In the letter of intent dated January 18, 2002, Turkey stresses that the program aims to continue the strengthening of the banking system and its supervision structure that has been underway since 1999. Turkey also expresses his commitment to improve prudential regulation and supervision even further.

Draft legislation related to strengthening the effectiveness of BRSA has been submitted to Parliament but did not pass by the end of October 2003. This legislation

has been constituting an essential structural performance criterion for the IMF program. The Turkish government states that this legislation is expected to be passed shortly and certainly before the IMF board's consideration of the sixth program target for net international reserves by more than US\$7 billion. Moreover, to maintain the BRSA's independence, the Turkish Government enabled for the direct submission of the BRSA budget to Parliament under the new law for independent agencies in Turkey. The Turkish Government has also been taking other necessary measures to reform the banking system and to strengthen the supervisory framework. Another legislation designed by the government, for example, enables the transfer of regulation and supervision of non-bank credit institutions from the Treasury to the BRSA.

Turkey has submitted last letter of intent to IMF on April 2, 2004. According to this letter, by the end-April Turkey completes the review of the Banking Act and prepares draft amendments to strengthen the Banking Act in line with EU standards. Areas that receive particular attention include: (a) proper criteria for on-site inspections; (b) legal protection of BRSA and SDIF staffs for actions taken during the course of their duties; and (c) delineation of responsibilities between BRSA and SDIF. The separation of the Boards of the SDIF and BRSA has been completed. This separation facilitates asset recovery and allows greater concentration by the BRSA on its supervisory responsibilities.

The recent experiences of BRSA have revealed that the banking supervision and regulation in practice is much more complex than issuing laws to establish regulatory and supervisory institutions. In Turkish context, private lobbies were resistant to any types of regulations in Turkish financial sector. They pressured the newly founded organization not to deviate from status-quo. The politicians and policy

makers were not very enthusiastic for the independent BRSA to function in Turkey considering that they perceived private banks as a major mean of government financing and the public banks to sustain their electoral support. As a result, IMF's efforts to design a new institution without internalizing the political and institutional problems in the construction of an autonomous and effective regulatory institution turn to a complete failure. Onis (2003), Alper & Onis (2003a-b) emphasize this aspect of financial system reforms in Turkey. Alper & Onis (2003a-b) denote the problems in engineering reforms in a top-down fashion while disregarding political legitimacy needed for effective implementation of the IMF sponsored reform programs. In the next section, we analyze the performance of the Turkish BRSA in detail.

## **6. Analysis of the Turkish BRSA's Independency**

Turkish BRSA has been founded according to IMF and WB suggestions as an independent institution. Nevertheless, it has not had an appropriate organizational structure and legal framework to work effectively and efficiently from September 2000 to now. There are many internal and external factors underlying for this unsuccessful performance. The essential requirement is then to uncover of these factors that cause the BRSA to fail. This analysis will form a reference for subsequent countries that follow the IMF and WB policy recommendations. The analysis of this topic in Turkish context also portrays a new direction for these international financial institutions to modify their suggestions so as to get better outcomes from cross-country applications. Hence, we analyze fundamental reasons for the unsuccessful performance of the BRSA below. Some of these are macro factors because they can not be solved solely by the BRSA. On the other hand, micro factors are related to the structuring of BRSA and easier to tackle for the effective functioning of BRSA.

## **6.1. Status-Quo Bias in Turkish Administrative Structure**

In spite of decentralization efforts after 1980s, organizational structure of Turkish government is still highly centralized. Centralized bureaucratic system has long historical path dependence in Turkish context. As a result of this general convention, until recent years, independent agencies within the government have not been very prevalent organizational forms in Turkey. The first independent authority, Insurance Supervisory Board, was established for supervising private insurance companies in 1959. Capital Market Board (1981), Radio and Television Supreme Council (1994), Turkish Competition Authority (1994), Consumer's Council and the Arbitration Council for Consumer Problems (1995) and the Banking Regulation and Supervision Agency (1999) are established by law as independent authorities within the government to monitor the activities of governments. Currently, there are also numerous other independent regulatory authorities that were activated for regulating and supervising various markets such as tobacco, energy, telecommunication markets. (Activeline, November 2004). Overall, it is apparent in the Turkish context that momentum toward independent regulatory authorities was triggered by the financial crises and the subsequent efforts of international institutions rather than by the increasing public awareness and the resulting political actions.

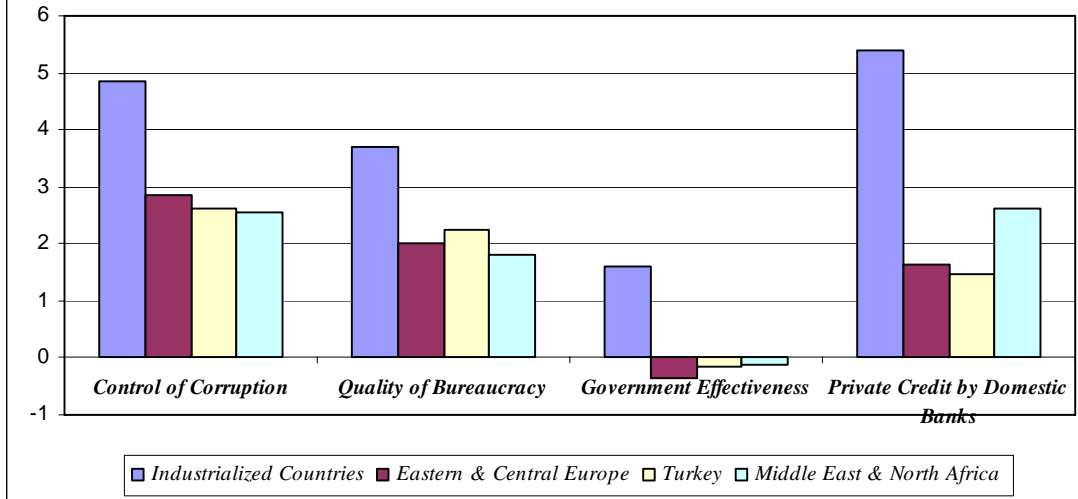
Even though some other branches of government have restructured as independent authorities similar to Turkish BRSA, they have not generated vivid policy discussions. This intensity of discussion on the independence of Turkish BRSA stems from the fact that banks have a significant power in Turkish political arena in addition to being dominant players in Turkish financial system. This reason also explains why the IMF and the World Bank are so insistent in creating an independent authority for supervising and regulating the banking sector.

Highly centralized government structure does not easily accept transferring power to an independent and decentralized financial authority. For example, in the new Banking Law, the timing of establishment of BRSA was set to be in June 1999. However, the BRSA could not become operational on a specified date. Threefold coalition government constituted a main reason for this delay. The coalition government did not reach a conclusion in appointing the Board of directors for the BRSA that were consisted of one president and six members. The process has been delayed in spite of endemic problems in the Turkish banking sector such as connected lending and extreme moral hazard. Hence, it was clear that the coalition government was not ready to deviate from the existing organizational structure in governing the Turkish financial system.

Another example for the resistance of conventional governance in this context can be seen in the intensity and severity of destructive criticisms for the newly established organization. Although the BRSA is a relatively young institution, it received an intense criticism against its activities from media, powerful interest groups, and other institutions within the government and even sometimes from the government which initiated the establishment of independent BRSA. These severe criticisms actually disclose some clues that the conventional governmental system in Turkey is not very much willing to lose power against an independent authority in the financial system. Figure 1 portrays the performance of existing governance structure in Turkey from a comparative perspective. It also displays the level of private credit provided by domestic banks as a standard indicator of level of financial development.

**Figure 1. Quality of Governance and Financial Development: A Comparative Perspective**

**Source:** Authors' calculations from International Country Risk Guide, Governance Matter III, Kaufmann et al. and Financial Data Set of Demirguc-Kunt et al.



## 6.2. Concentration Issue: The Dominant Role of Public Banks in Turkish

### Banking Sector

Turkish banking sector is characterized with two main inherent issues. First, the state-owned banks (mainly three banks) allocate a significant fraction of total financial assets in Turkey. Table 1 reports the concentration ratio in Turkish banking sector. Although, the share of the state-owned banks has declined in last fifteen years, from 45 percent to 33 percent, the state-owned banks still have a prominent asset share and dominant role in the banking sector. In 1999, Turkish government initiated a banking restructuring program in line with the policy recommendations of IMF. In this restructuring program, reorganization of the state-owned banks emerged as the major piece of the program. In spite of a considerable decline in the share of state-owned banks, currently the share becomes stable at 32-33 percent level.

Despite the reduction in the share of state-owned banks in the banking sector, the state-owned banks still control one third of the total banking sector assets. This dominance of government banks reduces the effectiveness and independence of BRSA. Given that government appoints the managers of both the banks and the BRSA, conflict of interest occurs when the BRSA make a decision over the state-owned banks while acting independently.

**Table-1**  
**The Concentration and Dominance in Turkish Banking Sector**

	1990	1999	2000	2001	2002	2003	2004(June)
Public	45	35	34	33	33	33	33
Private	44	49	46	55	56	57	57
Foreign	3	5	7	3	3	3	3
Under SDIF Management	-	6	9	5	4	3	3
<b>Total of Commercial Banks(Depository)</b>	<b>93</b>	<b>95</b>	<b>96</b>	<b>96</b>	<b>96</b>	<b>96</b>	<b>96</b>
Development and Investmet Banks (Nondepository)	8	5	4	4	4	4	4
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
<b>First Five Banks</b>	<b>54</b>	<b>46</b>	<b>48</b>	<b>56</b>	<b>58</b>	<b>60</b>	<b>60</b>
<b>First Ten Banks</b>	<b>75</b>	<b>68</b>	<b>69</b>	<b>80</b>	<b>81</b>	<b>82</b>	<b>82</b>
<b>First Five Private Banks</b>	<b>-</b>	<b>-</b>	<b>33</b>	<b>-</b>	<b>44</b>	<b>45</b>	<b>44</b>

Source: Banking Regulation and Supervision Agency, Annual Reports 2000, 2001, 2002, 2003; Banking Regulation and Supervision Agency, Banking Sector Development Report, October 2004; Turkish Bankers Association, Banks in Turkey 2000, 2001, 2002, 2003

Second problem in Turkish banking sector is again related to concentration issue. Aside from the state-owned banks, only a few private banks remain dominant in the Turkish banking sector as it is evident from the last row of Table 2. This factor also affects the BRSA's effectiveness and its independency. As discussed previously in this paper, existing research come to the conclusion that the independence from industry is the main requirement for the independent RSA. Since there is a positive relationship between the political power and the interest of the big banks at stake, it is more likely that big banks exert more efforts to influence the politicians when RSA acts independently. Moreover, big banks suffer less from the collective action

problem (Olson, 1965). This high concentration of handful of private banks has adverse consequences to fulfill the independency of BRSA in practice.

Another reason that may restrict the BRSA's actions to regulate the banking sector with high concentration ratio stems from the "too big to fail hypothesis". This problem is valid both for the big private and the state-owned banks. When these banks have certain difficulties, the BRSA may be constrained in giving sound decisions while considering the negative impacts of its decisions on the stability of financial markets as a whole.

The Pamukbank case represents a typical example for this problem. Although this bank lost its financial strength for a long time, both the banking authority and the BRSA did not take any actions against the Pamukbank (BRSA 2002). Moreover, the BRSA delayed the decision to transfer the bank's management to the SDIF. However, the same problems are likely to recur considering the structural deficit of high concentration of few public and private banks in the Turkish banking sector.

### **6.3. Employees Groups with Conflicting Backgrounds**

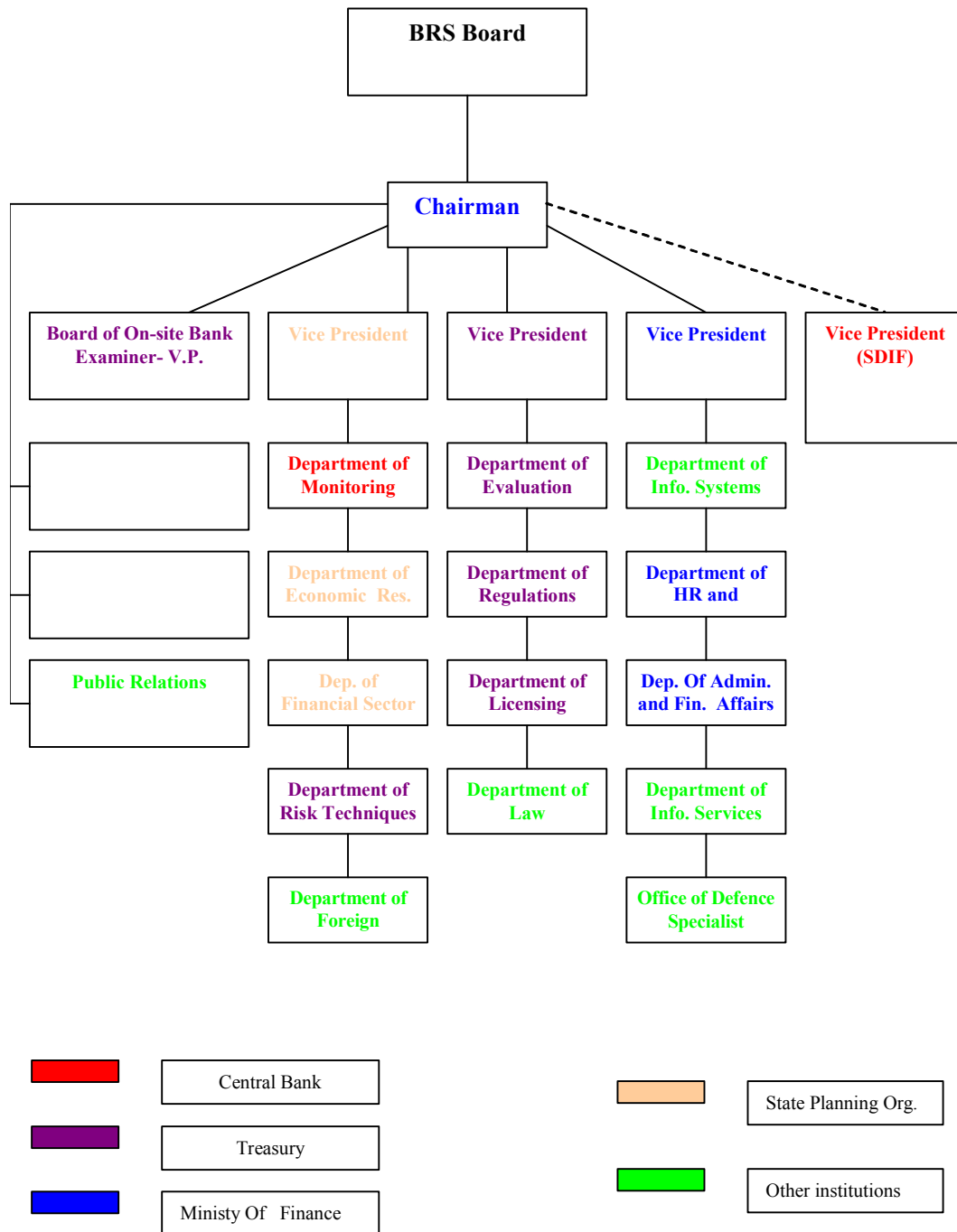
Before the establishment of the BRSA, monitoring, evaluating and supervising activities of banking sector were carried out by the Treasury Department and Central Bank. Treasury Department had the responsibility to inspect the banking sector with its on-site examiners and the evaluation results were also applied by banking division. On the other hand, the Turkish Central Bank was required to monitor the banking system by its monitoring division. These two main functions were unified under the BRSA umbrella according to the new Banking Law in 1999.

During the establishment process, however, in addition to these branches of the Treasury and the Central Bank, different personnel groups who had worked at



various departments of Turkish government were also transferred to the BRSA from State Planning Organization, Ministry of Finance and from other institutions (Figure 2). Naturally, there were important differences in organizational backgrounds of these highly diverse groups of employees. In certain cases, some of the transferred employees were not even related to the banking sector, especially at the upper levels. As a result, the BRSA of Turkey have confronted with difficulties in coordinating its workforce and hence failed to run various divisions efficiently. This issue also affects the BRSA's budget independency in practice. We explain this issue in details later in the paper.

**Figure 2: Organizational Chart of the BRSA  
(When Established)**



Source: BRSA, Annual Report of 2000.

#### **6.4. Accountability and Transparency Problems**

The BRSA has been proposed and founded as an independent agency according to the Banking Act of 4389. The main organizational structure of BRSA was also designated in this Act. Although there were many small details emphasized in this Act, accountability and transparency issues of the BRSA are not well defined. For example, the legal consequences of its decision in the national law system are left unanswered. Moreover, a final authority that the BRSA is liable to for its operation such as the Turkish Parliament or Prime Minister is not explicitly mentioned in this Act. However, these issues are essential for the accountability and transparency of the BRSA.

Even though the BRSA is an independent regulatory and supervisory agency, its decisions may be vulnerable to populist dissent when the BRSA decides to transfer a bank's management to the SDIF or to cancel a bank's license. However, when the accountability and transparency issues are defined better, the BRSA perform its duties within a well-defined boundary rather than on the basis of ad hoc assumptions about its domain. This critical point has generated substantial inconsistency over the last five years and will continue to do that unless the accountability and transparency of BRSA are improved. For example, since accountability and transparency issues have not been determined well by the Banking Act today, the decisions of BRSA with respect to the transferring of banks to the SDIF were interrogated by both the Turkish Parliament and Prime Ministry.

The Kentbank and Demirbank cases illustrate this idea even more explicitly. The managements of these banks were relegated to the SDIF with a decision of BRSA during 2000-2001 financial crises. Subsequently, the main shareholders of these banks brought their case to the Turkish courts to revoke the BRSA's decision and to get the

managements of their banks back. After a long time, the main shareholders of these banks won their trials and thereby obtained the right to get their banks back. However, in the meantime, the SDIF sold the Demirbank to HSBC Group and decided to liquidate the Kentbank. Similar problems were also experienced in Türkbank and Tarişbank cases after these banks were transferred to the SDIF in 1997 and 2001 respectively (see SDIF, Annual Reports 2001, 2002, 2003).

The decisions of BRSA have turned out to be irreversible in practice given that the final status of these banks has also been accepted by the Turkish courts. However, this de facto resolution has generated a great confusion and complexity in the Turkish financial markets and increased the suspicion about the basic activities of BRSA. Ability to bring a law suit against the BRSA is a good indicator for the just law system. However, considering the characteristics of the banking sector in Turkey, the court's decision created more issues for the Turkish banking system rather than delivering justice. Because of these reasons, the legal framework for the BRSA must be determined and justified well. Otherwise, the independency without accountability and transparency exacerbates irregularities even more in the financial markets.

### **6.5. Budget Independency Problem**

The budget independency constitutes one of the essential contributing factors for independency of RSB. The banking act for the establishment of BRSA states that the BRSA affords its expenses from funds provided by the Turkish banks depending on their balance sheet total in the preceding year (Article 6 of Banks Act No: 4389; Article 101 of the New Banking Act No:5411). Hence, the BRSA has budget independency that was rendered with the latest banking law (BRSA 2001). However, pressure groups inside and outside the BRSA prevented this agency to realize budget

independence in practice. Currently, BRSA operates with standard budget procedures similar to other branches of Turkish government. This lack of independent budgetary procedure in practice undermines the primary objective of independent BRSA.

The internal resistance comes from the some departments that have the right to make expenditures of the Agency. As it is seen the Figure 2, the personnel of these departments and their vice president, also the first chairman of BRSA, came from the Ministry of Finance. They brought their organizational structure to the BRSA. As a result, application rules of BRSA's budget took a shape closer to the general budget rules. Hence, the organizational backgrounds of these employees harmed the budget independency of BRSA.

At the outside of BRSA, as a part of general resistance for the independent agency, the budget of BRSA and its financial facilities are reported with exaggerations by other governmental departments and the mass media. In reality, however, the BRSA had just enough budgets to operate its functions regularly. Moreover, on the contrary to general false impression, the BRSA does not even provide an adequate amount of compensation to its qualified staffs commensurate to the banking sector average. This point is also pointed out in various Letters of Intents given to IMF. In addition to this, salaries of top managers are also low as compared to their responsibilities.

Lastly, the current government attempts to reorganize all independent regulatory and supervisory authorities. This amendment proposes the salaries of the top managements and personnel to correspond to a certain proportion of the salary of the Undersecretary of Prime Minister regardless of the importance of the agency. Moreover, another pressure comes for its revenues such that the governments can

transfer some portion of BRSA's revenues to the general budget. These proposals are likely to deteriorate the independence of BRSA even further<sup>§§§</sup>.

## **6.6. Restrictions on the BRSA's Board Members**

BRSA's board consists of seven members, including a chairman and second chairman. The Banking Act of 4389 brought some requirements related to educational and professional background to be a member in the board. In addition to these general requirements, there are some specific restrictions on the members of the board which are likely to create problems. The current Banking Act does not allow the board members to work at a financial institution for a specified period of time after their duties as board members are terminated. This constraint makes it more difficult to appoint professionals from the Turkish financial sector. Hence, the retired bankers, government bureaucrats and politicians are appointed in spite of their lack of capability and/or expertise in the banking sector. The lack of enough compensation mentioned in the previous section also inhibits the BRSA to hire competent professionals for its board.

Although the Banking Act prohibits working at the financial sector after leaving the board, it does not restrict the old board members to be active politicians. However, the incentive to engage in political activities harms the independency of the board's members and makes them more vulnerable to political pressures. Hence, one needs to think of the independence of BRSA as a dynamic process and takes into account how the expected political gains of the board members affect their current decisions.

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<sup>§§§</sup> This proposal has been incorporated in the new Banking Act in November 2005.

Related to this issue, some members, especially chairman and second chairman, may use these positions as a stepping stone to participate in politics. Hence, with this motivation at the background, they are more likely to adopt populist policies and to make certain hidden investments for their own political careers. The recent Turkish experience offers a plenty of evidence for this case in last five years.

Finally, we want to point out a different aspect of independence which is crucial in the Turkish context. In addition to independence from the political interference and from the supervised entities, the regulatory and supervisory body needs to be independent from the pressures of international financial authorities. In the Turkish case, the international institutions emerge as other actors in shaping the domestic policies; when the bureaucrats in the independent authorities opt to form coalitions with the international institutions against the nationally elected governments to implement their preferred economic policies.

These examples illustrate that independency highly depends on the incentive system given to the board members. It is definitely reasonable to prohibit old board members to work at the financial institutions in an attempt to reduce regulatory capture. However, certain provisions and securities for the board members need to be provided to compensate their future losses especially considering that in the current context, only the political options seem to be accessible for the board members\*\*\*\*.

### **6.7. Insufficient Regulatory Forbearance**

The rule of law has a vital importance for the independence of regulatory and supervisory authority. After 1980s, the financial system of Turkey has been liberalized and many restrictions have been eliminated such as interest rate ceilings

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\*\*\*\* Fortunately, there exist some improvements in the new Banking Act in November 2005.

and certain banking service regulations. However, the current law system has not been improved to accommodate the changing needs and circumstances of the Turkish financial system. Although governments have made piecemeal changes in the Banking Acts, the current financial laws are still lacking in providing a solid foundation for the healthy operations of the Turkish financial system.

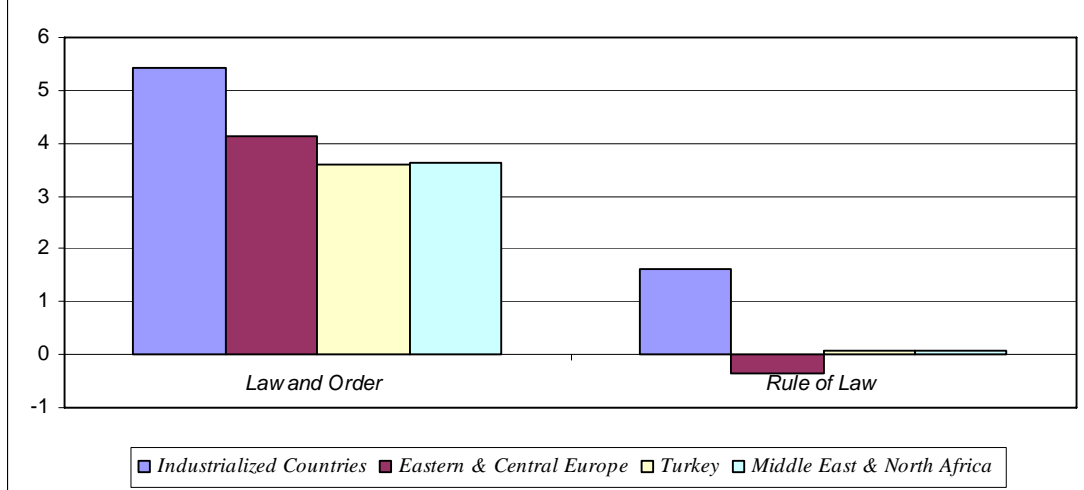
The recent experience of Turkey shows it once again that when the regulatory forbearance is insufficient, the regulations intended for the banking crimes are not really deterring. The legal infrastructure is not supportive and coherent with the BRSA's regulations. In Turkey, despite the existence of strict laws governing the banking crimes, there are difficulties in actually implementing these laws. For example, many preventive rulings have been given against the connected lending and looting issues. Moreover, managements of more than twenty banks have been transferred to the SDIF. Currently, most of these cases are pending trials at the Turkish courts, because the trial process lasts so long in Turkey. As a result of this sluggish functioning of Turkish courts, nobody in these trials has yet been sentenced on the basis of the connected and looting lending.

Another problem arises due the inconsistency between the private law governing the financial institutions and the general law. Turkey does not have law courts specialized in the financial issues. Hence, any decision given by the BRSA on banking sector issues is easily nullified by a general court. This lack of coherence leads to even less regulatory forbearance and impairs the functioning of independent BRSA in Turkey.



**Figure 3. Quality of Rule of Law: A Comparative Perspective**

**Source:** Authors' calculations from *International Country Risk Guide, Governance Matter III, Kaufmann et al.*



### 6.8. Conflicting Policy Recommendations by International Financial Institutions

International financial institutions encourage countries to have independent RSB. However, some of the policy recommendations of these institutions contain substantial internal conflicts and inconsistencies. Strict IMF policy requirements and targets as a part of stabilization programs after the crises in Turkey constrain the flexibility and capability of BRSA. For example, strict policy targets of the Turkish Central Bank which are supported by the IMF have led the Demirbank to be insolvent as a result of rational panics during the crises and subsequently, exacerbated the severity of Turkish crisis in 2001.

The Turkish governments have relied heavily on the domestic banks to rollover the domestic debt throughout the 1990s. The Demirbank was the major player in this domestic lending process. Even though its majority of assets consisted of the Turkish Treasury bonds, the Demirbank could not liquidate bonds to meet its

financial liabilities during the 2001 financial crisis. The central issue was to fulfill the requirement of IMF for the “net domestic assets” of the Turkish Central Bank. This constraint invalidated “the lender of last resort” responsibility of the Turkish Central Bank. This case illustrated the third type of independence which is the independence from the pressures of international organizations especially when the national interest clashes with the policy recommendations of the international institutions. This case further uncovers the need for coherent but flexible policy recommendations by the international organizations.

### **6.9. Public Pressure on the BRSA’s Tough Decisions**

After the recent Turkish crises, the BRSA took over the insolvent banks. Some of the banks are closed and others are reorganized and merged under several banks. As a consequence of this restructuring, many people have lost their jobs over the last five years (see Table 2). This social dimension of crises generated an intense public pressure against the activities of BRSA. This pressure is also supported by the politicians to redirect the public discontent to a tangible organization. However, the outcomes of BRSA’s actions and decisions deteriorated the popularity of last coalition government. Finally, this government, not surprisingly, lost the national election.

In retrospect, the coalition government seems to bear the burden of adverse effects of the BRSA’s decisions on society. However, in reality, a policy approach to sweep the banking sector problems under rug has come to the end with the increasing awareness led by the sudden stop associated with crises in Turkey. With respect to the independence of BRSA, recent Turkish experience shows that the decisions of independent authority are also influenced by the social concerns. Prospective public

pressure against the unpopular policies of the BRSA is only alleviated when it is made clear to whom the BRSA is accountable in the Turkish governmental organization.

**Table-2**  
**The Number of Employees in Turkish Banking Sector (1999-2004)**

	1999	2000	2001	2002	2003	2004(June)
Public	71.801	70.191	56.108	40.158	37.994	37.231
Private	75.518	70.954	64.380	66.869	70.614	73.722
Foreign	4.782	3.805	5.395	5.416	5.481	5.553
Under SDIF Management	15.975	19.895	6.391	5.886	4.518	4.277
<b>Total of Commercial Banks(Depository)</b>	<b>168.076</b>	<b>164.845</b>	<b>132.274</b>	<b>118.329</b>	<b>118.607</b>	<b>120.783</b>
Development and Investment Banks (Non-depository)	5.836	5.556	5.221	4.942	4.642	5.491
<b>Total</b>	<b>173.912</b>	<b>170.401</b>	<b>137.495</b>	<b>123.271</b>	<b>123.249</b>	<b>126.274</b>

**Source:** Banking Regulation and Supervision Agency, Annual Report 2001; Banking Regulation and Supervision Agency, Banking Sector Development Report, October 2004; Turkish Bankers Association, Banks in Turkey 2003

## 7. Conclusion

Globalized financial markets appear to be vulnerable to crises more than ever before. The experiences of developing countries in the recent decades confirm that well-functioning financial markets require constant monitoring and sound regulation of financial markets. Even though we do not observe discrete steps to improve the stability of international financial markets, there are significant attempts to fix the deficiencies in domestic financial markets of individual countries. Efforts to establish independent regulatory and supervisory agencies across the countries are notable in this direction. International institutions like the IMF and the World Bank also play a significant role in setting up these independent regulatory authorities in various countries. The loan conditionality of IMF accelerates the institutional reform process of many countries in adopting the independent authorities to regulate their financial systems. Turkish case stands one of the recent examples for this IMF-led institutional change to construct an independent regulatory and supervisory authority for the

Turkish banking sector. The Turkish experience in the construction of this independent authority provides a novel perspective for the failure of engineering an institutional restructuring in a top-down manner without accounting for the preconditions for the successful institution reform.

This paper investigates the reasons for the failure of Turkish BRSA to function effectively over the last five years. Status-quo bias in Turkish administrative structure and high concentration ratio of state-owned banks as well as the few private banks prevent the BRSA to reach to its desired level of independence in its decision making process. Different employee groups with conflicting backgrounds also reduces the efficiency of the BRSA. This factor also contributes to the lack of budgetary independence for the BRSA which is necessary to achieve some level of independence to reduce the political and special interest group pressures. We also illustrate that strict restrictions on the BRSA's board members open a new avenue for even more political intervention on the actions of the BRSA. Moreover, the accountability and transparency of BRSA need to be defined better. Current structure seems to be giving complete authority to the BRSA in its regulatory and supervisory responsibilities. However, this unlimited responsibility generates even more hesitant policy decisions by the BRSA. This lack of well-defined boundaries in exercising the power of BRSA leads the public to be more skeptical about the resolutions of BRSA. Some of the factors for the failure of BRSA in effectively delivering its responsibilities are related to macro factors which are outside the control of BRSA. For example, insufficient regulatory forbearance is a general problem of governance in Turkey. Finally, Turkish example offers a rather fitting example for the failure of IMF in providing consistent and flexible policy recommendations. This factor has also

contributed to the failure of BRSA in providing competent and effective regulatory and supervisory framework after the recent crises in Turkey.

Since preconditions are not well explored prior to giving certain policy recommendations, the Turkish BRSA, at this moment, has to indulge in inefficient activities and spend its most precious time to sustain its independency instead of focusing on regulating and supervising the Turkish banking sector. The Turkish experience reveals that in developing countries like Turkey, before legally founding a regulatory and supervisory agency, the international financial organizations need to focus on certain prerequisites and need to provide convenient environment for these agencies to operate. Otherwise, independent regulatory and supervisory institutions fall short of implementing their duties efficiently and effectively.

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